

STATE OF VERMONT
PUBLIC SERVICE BOARD

Docket No. 6866

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| Investigation into Memorandum of Understanding |) | Hearings at |
| between Central Vermont Public Service Corporation |) | Montpelier, Vermont |
| and Vermont Department of Public Service |) | December 9 and 10, 2003 |

Order entered: 1/27/2004

PRESENT: Michael H. Dworkin, Chairman
David C. Coen, Board Member
John D. Burke, Board member

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I. INTRODUCTION

In this Docket, the Vermont Public Service Board ("Board") reviews a Memorandum of Understanding between Central Vermont Public Service Corporation ("Central Vermont" or "Company") and the Department of Public Service ("Department") which, in general terms, restricts Central Vermont's ability to seek an increase in rates this year, reduces Central Vermont's allowed return on equity from 11.0 percent to 10.5 percent, and requires any earnings in excess of the allowed return to be applied for the benefit of Central Vermont's ratepayers. The Memorandum of Understanding was filed in response to the Board's Order of June 13, 2002, in Docket No. 6545, requiring consideration of a possible rate decrease for Central Vermont.

The record in this proceeding reveals that the Memorandum of Understanding provides only modest benefits to Central Vermont's ratepayers. It does not provide for a rate reduction, but does provide that, absent extraordinary circumstances, Central Vermont cannot file for a rate increase to take effect prior to January 1, 2005. The Memorandum of Understanding extends the pre-existing cap on Central Vermont's earnings which, absent the Memorandum of Understanding, would have expired at the end of 2003. The Memorandum of Understanding also lowers that cap from 11.0 percent to 10.5 percent, effective July 1, 2003.

Despite these benefits, we have determined that we can only approve the Memorandum of Understanding with significant added conditions, due to a material deficiency in the agreement as presented: the Memorandum of Understanding fails to make any meaningful progress toward reducing Central Vermont's undesirably large deferred expense balances. Our inquiry in this case revealed that Central Vermont's deferred expense balances increased by over 50 percent — from \$31.2 million to \$47.3 million — in less than two years (December 31, 2001, to September 30,

2003). Compounding the problem, Central Vermont apparently has been reducing the amounts that it writes down from these accounts. Although we pressed Central Vermont and the Department to propose ways to correct this problem,¹ they did not present us with an effective alternative.

Avoiding rate increases is strongly desirable, and we do not fault the Department or the Company for pursuing that goal. However, level rates for current ratepayers must not be achieved by excessively deferring costs for future ratepayers to bear.

Because we are deeply concerned about the magnitude of, and in particular the recent substantial increase in, Central Vermont's deferred expense accounts, and because the Memorandum of Understanding does not adequately address this problem, in today's Order we condition its approval with specific requirements designed to accelerate the recognition of Central Vermont's deferred costs. These requirements are designed to provide greater assurance to present and future ratepayers that, as a matter of intergenerational equity,² their rates will include only their fair share of costs.

We also conclude that the allowed return on equity proposed in the Memorandum of Understanding is too high. Rather than the 10.5 percent that Central Vermont and the Department propose, we conclude that the Company's return should be set at 10.25 percent, a level more commensurate with existing market conditions and with Central Vermont's relatively low risk profile.

If Central Vermont (or the Department) rejects the Memorandum of Understanding as we have modified and conditioned it, we are likely to open an investigation into (a) the justness and reasonableness of Central Vermont's rates, and (b) the appropriate accounting treatment of Central Vermont's deferred expenses. Given Central Vermont's currently favorable financial position, it must either decrease its rates, for the benefit of current ratepayers, or reduce the costs that it is currently deferring, for the benefit of future ratepayers.

1. Tr. 12/10/03 at 139–141 (Chairman Dworkin).

2. Intergenerational equity is the principle that current and future ratepayers should only bear those costs that are fairly attributable to the service that they, respectively, receive. This principle is well-established in Board precedent (see, for example, our Order of 2/8/96 in Docket Nos. 5810/5811/5812, at 25–26, 40–41), and is further discussed below in Section IV.B.2 of this Order.

II. PROCEDURAL HISTORY

The Memorandum of Understanding arises from the Board's 2002 Order in Docket No. 6545 in which the Board approved the sale of the Vermont Yankee Nuclear Power Station ("Vermont Yankee") to Entergy Nuclear Vermont Yankee, LLC ("Entergy"). The evidence in that case demonstrated that the sale and the simultaneous entry into the Power Purchase Agreement under which the prior owners of Vermont Yankee would purchase power from the plant would provide benefits to the state of Vermont and was, therefore, in the best interest of the state. One of these benefits was a reduction in expected costs for Central Vermont and Green Mountain Power Corporation ("Green Mountain"). The Board found, however, that these cost reductions might not benefit ratepayers directly, absent an adjustment of rates. To ensure such benefits for customers, the Board ordered:

Central Vermont and Green Mountain to each file, on or before April 15, 2003, a cost-of-service study based upon actual 2002 data. The cost of service study will enable the Board and Department to determine whether an adjustment to rates is justified in 2003 or 2004.³

Central Vermont filed its cost-of-service study in a timely manner on April 15, 2003. After the Department reviewed Central Vermont's filings, the Department and Central Vermont entered into settlement discussions, which, after several requests for extensions, resulted in the Memorandum of Understanding that we consider in this Order. Central Vermont and the Department filed the Memorandum of Understanding on July 11, 2003, in Docket No. 6545, requesting that the Board approve the arrangement. The primary components of the Memorandum of Understanding are as follows:

- During 2003, 2004, and 2005, if Central Vermont's Return on Equity ("ROE") for its Vermont utility operations exceeds 10.75%, 10.5%, or 10.5%, respectively, Central Vermont will use the excess earnings to write down regulatory assets or otherwise benefit ratepayers.

3. Docket No. 6545, Order of 6/13/02 at 136.

- Central Vermont may not request a rate increase for rates effective prior to January 1, 2005, except in very limited circumstances.
- Central Vermont will file a proposed rate design within 60 days.
- Central Vermont and the Department will negotiate in good faith the development of an alternative-regulation plan, with a target for filing such a plan by March 31, 2004.

The Board opened an investigation in Docket No. 6866 to consider the Memorandum of Understanding, convening a Prehearing Conference on September 30, 2003. The Board granted a motion to intervene filed by AARP. Evidentiary hearings on the Memorandum of Understanding took place on December 9 and 10, 2003.

III. POSITIONS OF THE PARTIES

Central Vermont and the Department each request that the Board accept the Memorandum of Understanding. Central Vermont and the Department contend that the Memorandum of Understanding will provide ratepayers with substantial benefits that could not be obtained without the Company's consent. According to Central Vermont and the Department, those benefits include a reduction in the Company's return on equity, an extension and lowering of the earnings cap that was established in the last Central Vermont rate case (in 2001), and a continuation of the Company's rate freeze through the end of 2004. Central Vermont claims that the Memorandum of Understanding provides further benefits through the development of a rate redesign and its promotion of an alternative regulation plan.

AARP asks that the Board reject the Memorandum of Understanding. AARP contends that Central Vermont's return on equity should be no higher than 9.5% to 10.0 %, and that the Company has approximately \$37 million in deferred debits and potential regulatory assets. AARP claims that the Memorandum of Understanding, with a return on equity set at 10.5 %, will result in the Company's shareholders receiving excessive payments that should instead be applied to reducing the deferred debits. AARP asserts that the Memorandum of Understanding could be improved if the return on equity were reduced to a proper level, and if excess earnings were

shared between Central Vermont's shareholders and ratepayers. According to AARP, an even better alternative—and the course that AARP recommends—would be for the Board to open an investigation into Central Vermont's rates.

IV. CENTRAL VERMONT/DEPARTMENT MEMORANDUM OF UNDERSTANDING

A. Findings

1. Cost of Service

1. Under the Memorandum of Understanding, the Department and Central Vermont agree that a change in the Company's retail rates in 2003 and 2004 is not warranted. Exh. CVPS-JHG-1, ¶ 9.

2. Under the terms of the Memorandum of Understanding, Central Vermont may not file for a rate increase for rates effective prior to January 1, 2005, except that, in the event of a major storm, power supply interruption or outage in excess of forecasted outage rates relating to Vermont Yankee or Hydro-Quebec deliveries, Central Vermont may seek emergency rate relief pursuant to 30 V.S.A. § 226(a) or seek an accounting order from the Board permitting deferral of costs associated therewith. The Department has agreed to support any such request for an accounting order, with the Department also retaining its right to contest the ultimate recovery of such booked and deferred costs. Exh. CVPS-JHG-1, ¶ 9.

3. The Memorandum of Understanding provides that if Central Vermont's calendar-year earned rate of return on common equity from its Vermont electricity utility operations in 2003, 2004 or 2005 exceeds 10.75%, 10.5% or 10.5%, respectively, Central Vermont will apply the excess first to reduce Account 186.0 (Miscellaneous Deferred Debits) as approved by the Board at the time of such excess returns, and thereafter as otherwise agreed by Central Vermont and the Department and approved by the Board. Central Vermont will file a report on March 1 of 2004 and 2005 detailing its core return on equity from the previous calendar year. Exh. CVPS-JHG-1, ¶ 11; Behrns pf. at 5–6.

4. Based upon analyses of returns on equity using the Discounted Cash Flow, Capital Asset Pricing Model, and Risk Premium methodologies, the zone of reasonable returns on equity for Central Vermont ranges approximately from 9 % to 10.5 %. Tr. 12/10/03 at 10–19 (Talbot);

Talbot pf. at 11–26; exh. Board-1; exh. Board-5; Cater pf. at 2; Lesser pf. at 3–4; exh. DPS-1 at 49.

5. Actual earned returns on common equity for electric utility companies similar to Central Vermont currently average 9.50%. Talbot pf. at 22.

6. Long-term and short-term interest rates are close to their lowest levels in over four decades. According to the Federal Reserve Board's statement on October 28, 2003, interest rates are likely to remain low in the near future. Talbot pf. at 23–25.

7. Generally, companies with a higher degree of risk are accorded a higher return on equity. Cater pf. at 4.

8. The electric utility industry has experienced a period of turmoil associated with partial deregulation and restructuring. Regulated utilities like Central Vermont are relatively stable from an investor standpoint. Talbot pf. at 23–26.

9. Central Vermont is less risky than Green Mountain from a financial standpoint. Central Vermont has considerably less long-term debt, a lower beta, a higher interest coverage ratio, and a higher market capitalization.⁴ Talbot pf. at 5–6.

10. Investors are likely to perceive Central Vermont as a less risky investment than is Green Mountain. Based on previous rate proceedings and current conditions, a reasonable estimate of this risk difference is between 25 and 50 basis points. Talbot pf. at 28.

11. The Board recently approved a return on equity of 10.5 % for Green Mountain, in the context of approving a Memorandum of Understanding between Green Mountain and the Department. Docket No. 6867, Order of 12/22/03 at 16, 42.

12. A lower return on equity in the Memorandum of Understanding would allow Central Vermont to write down deferred debits that would otherwise remain, thus benefitting ratepayers. Tr. 12/10/03 at 134–136 (Behrns).

4. Additionally, the Board found Green Mountain to have a higher risk relative to other electric utilities as a result of the significant portion of its load that is committed to one retail customer. Docket 6867, Order of 12/22/2003 at 11 (Finding 6).

2. Deferred Accounts

13. In less than two years — from December 31, 2001, to September 30, 2003 — the total balance of Central Vermont's net regulatory assets has increased by more than \$16 million, from \$31.2 million to \$47.3 million, representing an increase of over 50 percent.⁵ Of the \$47.3 million in deferred costs, \$10.5 million are accruing carrying costs,⁶ with \$36.8 million not accruing carrying costs. Exh. Board-2 at 22; exh. Board-4; exh. Board-7; tr. 12/10/03 at 63–64 (Gibson).

14. As of December 31, 2002, Central Vermont's net regulatory assets were \$45.7 million, comprised of the following:

- (a) \$22.8 million of deferred charges that were being amortized;⁷
- (b) \$24.1 million of deferred charges that were not being amortized; and
- (c) \$1.3 million of deferred credits.

Exh. Board-2 at 22; tr. 12/10/03 at 62 (Gibson).

15. It is highly desirable for Central Vermont to write down its deferred expenses as soon as possible, thereby eliminating (or substantially reducing) the deferred debits from its balance sheet.⁸ Central Vermont's deferred debits should be addressed in the context of its cost of service filing, upon which the Memorandum of Understanding is based. Tr. 12/9/03 at 100–117 (Gibson); Behrns pf. at 2–3, 5–6; exh. CVPS-JHG-1 at 1–3.

16. Central Vermont and the Department propose to address the deferred debit balances through the earnings cap. The proposed earnings cap would reduce Central Vermont's deferred balances by the amount of any earnings in excess of the allowed return on equity. Behrns pf. at 6; Gibson pf. at 5–6; exh. CVPS-JHG-1, ¶ 11; finding 3, above.

5. On December 22, 2003, Central Vermont filed a letter stating that it will receive its share of a "NEIL" refund, approximately \$1 million, as a credit on its January, 2004, Vermont Yankee power bill. (We note that this refund represents only a portion of the total expected NEIL refunds.) Central Vermont represents that it will apply its refund to reduce the deferred debit relating to the Vermont Yankee fuel rod repair costs.

6. The estimated rate for carrying costs in 2003 is 9.329%. Exh. Board-4.

7. The record is unclear as to how quickly Central Vermont is amortizing these deferred costs.

8. As the Department's witness testified, "These deferred expenses need to be cleared from the balance sheet as soon as is practicable." Behrns pf. at 6.

17. The Department was not fully aware of the magnitude of Central Vermont's deferred balances at the time the Department negotiated the Memorandum of Understanding. Tr. 12/10/03 at 124–132 (Behrns).

18. Given the magnitude of Central Vermont's deferred account balances, the Memorandum of Understanding fails to adequately address those balances. The Memorandum should have required increased amortizations of the deferred balances; one mechanism for accomplishing this would be a reduction in the return on equity allowed under the Memorandum. Tr. 12/10/03 at 134–135 (Behrns).

19. In its 2004 cost-of-service filing, Central Vermont included the following adjustments to its 2002 test-year data:

- (a) a \$1.75 million credit, representing a 1/12 amortization of an estimated \$21 million payment that Central Vermont will receive from Public Service Company of New Hampshire (Central Vermont's cost-of-service "Adjustment No. 1");⁹
- (b) a \$95,000 reduction to test-year cost of service, to reflect that current Conservation and Load Management amortizations have been fully written off ("Adjustment No. 23"); and
- (c) a \$2,122,000 reduction to test-year cost of service to reflect that current Accounts Correcting for Efficiency amortizations have been fully written off in 2003 ("Adjustment No. 24").

Exh. CVPS-JHG-2, Schedule 9; exh. CVPS-JHG-3 at 3, 10–11.

20. If Central Vermont were to continue to recover deferred charges in rates after the balance for those charges is eliminated, those recoveries would flow through to the Company's earnings. Such amounts should, instead, be applied to the amortization of other deferred accounts. Tr. 12/10/03 at 136 (Behrns).

21. Central Vermont's cost-of-service filing for 2004, which the Company contends demonstrates that no rate reduction is warranted for that year, includes as "Adjustment No. 34" an increase to the cost of service of \$2,527,000 to reflect the amortization of deferred costs, net of regulatory liabilities, that are not currently being amortized. Exh. CVPS-JHG-2, Schedule 9; exh. CVPS-JHG-3 at 13.

9. On January 9, 2004, Central Vermont filed a letter notifying the Board that it currently expects to realize an additional gain from the sale to PSNH.

22. The Company's 2004 cost of service assumes a return on equity of 11.0 percent. Exh. CVPS-JHG-2, Schedule 8.

3. Other Terms and Conditions

23. Under the Memorandum of Understanding, Central Vermont will file a revised rate design, supported by a fully allocated cost-of-service study, within 60 days of approval of the Memorandum of Understanding. Exh. CVPS-JHG-1, ¶ 12; Behrns pf. at 7.

24. The Memorandum of Understanding provides that Central Vermont will enter good-faith negotiations with the Department toward the development of an alternative-regulation plan, with a March 31, 2004, target for filing such a plan. The Memorandum of Understanding does not compel the filing of an alternative-regulation plan absent Central Vermont's agreement. Exh. CVPS-JHG-1 at 14.

B. Discussion

1. Cost of Service

In making a determination of an appropriate return on equity for utility companies, the principles described by the United States Supreme Court several decades ago remain relevant today. As the Supreme Court simply stated in 1923:

A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.¹⁰

10. *Bluefield Water Works & Improvement Co. v. Public Service Commission*, 262 U.S. 679, 692-93 (1923).

The Memorandum of Understanding proposes that Central Vermont's return on equity be reduced from its current 11.0% to 10.5%, effective as of July 1, 2003.¹¹ In today's Order, in light of the financial, managerial, and regulatory environment in which Central Vermont currently operates, and in consideration of the framework the Memorandum of Understanding in its entirety proposes, we conclude that a return on equity of 10.25% is more consistent with the longstanding, sound, and equitable principles, as set out in *Bluefield*.

Determining an appropriate return on equity is not an exact science, but rather requires the exercise of judgement to arrive at a fair result. The results of several accepted traditional methods the Board has typically weighed when establishing a fair return on equity — namely Discounted Cash Flow ("DCF") analysis, Capital Asset Pricing Model ("CAPM"), and risk premium methodology — were presented by Central Vermont, the Department, and AARP in their recommendations. And while each party used these methods correctly, we are left with possible "appropriate" returns on equity from below 8% to 11% or more. The range of possible returns on equity presented by the parties is as follows:

| | DCF | CAPM | Risk Premium |
|------|----------------|-----------------|----------------|
| CVPS | 9.97% - 10.96% | 10.29% - 11.05% | 9.21% - 10.97% |
| DPS | 8.32% - 12.89% | 8.54% - 10.63% | 9.50% - 10.61% |
| AARP | 7.60% - 10.60% | 9.15% | |

Within the broad range of returns presented by the parties, we conclude, for reasons discussed below, that a more narrow range, from 9% to 10.5%, is reasonable to frame the instant evaluation.¹²

11. Central Vermont's return on equity was set at 11.0%, effective 7/1/2001, in Docket 6120/6460, Order of 6/26/2001.

12. Curiously, the Department did not accept its own consultant's recommendation that a 9.0% return on equity was appropriate; and inexplicably, the Department also filed a study in Docket 6867 (included as part of Exhibit Board-1) that also supported a return on equity below 10%. See, *Report to the Vermont Department of Public Service Re: Central Vermont Public Service Corporation*, The Columbia Group, Inc., June 27, 2003 (Exh. Board-5); and *Why Are Allowed Rates of Returns Too High?* J. Randall Woolridge presentation to 2003 NASUCA Annual Meeting, November 19, 2003 (Exh. Board-1)("Allowed Returns on Equity Above 10% are Clearly Excessive".)

We allow a 10.25% cap on earnings for several reasons. First, economic conditions, expectations of the investment community, and the lower overall returns on risk-free investments support a lowering of the current 11% expected return on equity. Second, Central Vermont has a relatively low risk profile when compared to the industry as a whole, when compared to similarly capitalized utilities nationally, and when compared to Green Mountain. Third, we find that a lower return on equity cap will lead to a more expeditious write-down of Central Vermont's regulatory assets (a troubling circumstance which we address below), in the event Central Vermont's actual earnings exceed 10.25%. Consequently, we expect that a 10.25% cap on earnings will assure fairness to investors, while at the same time it will lead to a meaningful reduction in Central Vermont's cost of service from what it would otherwise be with a higher cap.

We note that 10.25% is within (and near the upper end of) the range of returns that we have found reasonable. We accept the placement near the upper end, rather than at the midpoint, for the following reasons. Such a return meets the *Bluefield* criteria by providing a fair return to the utility. Additionally, Central Vermont's equity assets are relatively low for a utility with comparable revenues; thus, each "point" of return on equity has a relatively low financial cost to ratepayers, yet may have a valuable impact on investor perceptions, which should (at low direct cost to ratepayers) benefit ratepayers by increasing Central Vermont's access to capital.

The overall economic climate in which we assess Central Vermont's required return on equity sees interest rates, inflation, stock returns, yields on bonds and treasury bills, as well as average utility company allowed and achieved returns on equity, at the lowest levels in decades. The electric utility industry has weathered a tumultuous period of restructuring and deregulation as well. Despite these conditions, Central Vermont has fared well over the last several years.¹³ Neither Central Vermont nor the Department have demonstrated why Central Vermont's return on equity cap should not be reflective of the changes seen in virtually all recent, comparative economic benchmarks.

13. By one obvious, though variable, measure – Central Vermont's stock price – Central Vermont has achieved a 40% return over the last two years, while the S&P index was slightly negative. Talbot pf. at 25-26.

Central Vermont contends that its relatively low bond ratings indicate a perception of risk that warrants a comparatively higher return on equity. Yet Central Vermont has failed to demonstrate how closely linked its bond ratings are to its risk profile. In one example that supports a contrary view, the recent sale of Vermont Yankee was partially justified by Central Vermont's assertion that it would be shedding a significant amount of risk. One would expect that having reduced such risk, Central Vermont's bond ratings would be commensurately higher. However, Central Vermont still finds its bond ratings "one notch above 'junk bond' status."¹⁴

Central Vermont faces very little regulatory risk in regard to its power supply. Central Vermont is virtually assured recovery for the majority of its power costs, from purchases from Hydro-Quebec, Vermont Yankee and Millstone nuclear power stations, small power producers, and its owned hydroelectric facilities. Central Vermont and the Department argue that the absence of a fuel adjustment clause (or, more appropriately, a purchased power adjustment clause), coupled with the implementation of Standard Market Design in the New England wholesale power market, introduces an element of risk that warrants a return on equity at the high end of stated ranges. Exposure to fuel price or purchased power price fluctuations is far less for Central Vermont than for many companies; this is because Central Vermont currently procures most of its power through defined-price contracts that have been approved by regulators. Thus, based on the existing power-supply arrangements, Central Vermont would benefit little, if at all, from a fuel adjustment clause.

One factor Central Vermont and the Department use to support the proposed 10.5% return on equity is a comparison to the returns on equity *authorized* in comparable utility rate cases. We find this comparison incomplete, in that *actual* returns, on average lower than authorized, provide an equally if not more relevant benchmark. Furthermore, the most comparable return on equity authorization — that of Green Mountain — supports the conclusion that a lower return on equity for Central Vermont is appropriate. For many years, Board rulings have recognized a difference in comparative risks and allowed (most recently) an 11.25% and 11.00% return on equity for Green Mountain and Central Vermont, respectively. We continue to

14. Gibson pf. at 12. The rating referred to is S&P's Corporate Credit Rating of BBB-. Central Vermont's rating was recently upgraded by the Fitch ratings agency, and Morningstar gives Central Vermont an "A-" for financial health. *Id.*; Talbot pf. at 6.

find that Green Mountain maintains a higher level of risk than Central Vermont. Green Mountain faces a high degree of dependence on one retail customer, a lower market capitalization, more long-term debt, and a slightly greater exposure to power purchased on the market. This difference in risk is likely a factor in Morningstar's "B-" rating for Green Mountain's financial health, versus an "A-" for Central Vermont.¹⁵ These comparisons suggest that Central Vermont should continue to have an allowed return on equity less than Green Mountain's.

Not only is 10.25% fair to the utility, in light of Central Vermont's excessive use of deferred accounts, we find it appropriate in order to allow a swifter recognition of, and cure for, the Company's high level of deferred accounts.¹⁶ Fortunately, such curative measures will, themselves, reduce the Company's real and perceived risks to investors. Central Vermont concedes that it may be seen to face additional risk because the Memorandum of Understanding does not assure the Company that it will recover its deferred costs.¹⁷ We expect that the expeditious and appropriate accounting treatment we require in conditionally approving this Memorandum of Understanding will, by the same logic, decrease the uncertainty associated with the Company's deferrals, thus lowering its overall risk.

The Memorandum of Understanding provides that if Central Vermont's return on common equity from its Vermont electricity utility operations in 2003, 2004 or 2005 exceeds the cap, Central Vermont shall apply the excess first to reduce Account 186.0 (Miscellaneous Deferred Debits) as approved by the Board at the time of such excess returns, and thereafter as otherwise agreed by Central Vermont and the Department and approved by the Board. If Central Vermont accepts the Memorandum of Understanding as conditioned by this Order, this provision will apply as written, though modified to reflect 10.625%, 10.25% or 10.25%, for treatment of excess returns in 2003, 2004 and 2005, respectively.

Finally, we note that the Memorandum of Understanding requires Central Vermont to file a report of its return on equity following calendar years 2003 and 2004, but not 2005. Because

15. Talbot pf. at 6.

16. See 12/10/03 tr. at 134 (Behrns) (a lower return on equity would allow for more amortizations).

17. Cater pf. at 6.

the earnings cap would apply through the end of 2005, we will add the requirement that Central Vermont file a similar report for calendar year 2005.

2. Deferred Accounts

Unlike the Memorandum of Understanding between the Department and Green Mountain that we recently approved,¹⁸ the Central Vermont Memorandum of Understanding offers the veneer of rate stability underlain with substantial cost deferrals. In approving the Green Mountain Memorandum of Understanding, we observed:

the Memorandum of Understanding and the rate freeze in 2003–2004 *is not predicated upon an excessive deferral of costs*. Green Mountain presently has approximately \$28.8 million in deferred costs that it will recover by amortizing the costs in rates. Except for costs associated with the Pine Street Barge Canal Superfund site and with ACE, these deferrals are now being amortized and that amortization is reflected in rates. Amortization for these two remaining accounts will begin January 1, 2005.¹⁹

In contrast, Central Vermont's levels of deferred charges are of significant concern, for at least three reasons. First, those charges would not be written down at a sufficient pace under the Memorandum of Understanding. The record before us demonstrates that, over the past two years, those deferred balances have been increasing substantially, yet the Memorandum of Understanding would permit Central Vermont to slow down the pace at which it clears the deferrals from its books, compared to its recent amortization levels.

Second, Central Vermont's cost-of-service analysis for 2004, upon which the Company relies for its contention that no rate reduction is required, includes \$2.527 million of new amortizations. The Memorandum of Understanding is based on the Company's cost-of-service filing, and thus provides for the maintenance of existing rates rather than a rate reduction, but does not require Central Vermont to actually recognize the \$2.527 million of amortizations on its books.

Third, deferrals result in current charges being passed on to future ratepayers, possibly resulting in intergenerational inequities. While it may be appropriate in some circumstances to

18. Docket No. 6867, Order of 12/22/03.

19. Docket No. 6867, Order of 12/22/03 at 18 (emphasis added)(footnote omitted).

spread costs over a number of years, we have noted on a number of occasions that it is inappropriate to require future ratepayers to bear costs that are not fairly attributable to the provision of service to them.²⁰

As a result of our concerns about the Company's deferral accounts, we bluntly noted at the evidentiary hearings in this Docket that a flat rate plan that fails to address Central Vermont's substantial deferred account balances is troubling, especially when (as here) it is accompanied by a return on equity that is at the high end of the reasonable range.²¹ We expressly asked the parties to address our concerns.²²

In response, Central Vermont included in its direct brief a proposed modification to the Memorandum of Understanding, in which the Department has concurred. Central Vermont and the Department suggest that the Memorandum of Understanding be modified as follows:

- a. Central Vermont would begin amortization of the approximately \$3.1 million of its Vermont Yankee fuel rod repair costs, beginning January 1, 2004, with the account to be reduced at a rate of \$640,000 per year. If these costs become fully amortized before the effective date of the next Central Vermont rate case, the same \$640,000 would be applied to the balance of the Vermont Yankee Sale Costs until fully amortized; and
- b. In return for the \$640,000 annual amortization, the "earnings cap" established in paragraph 11 of the Memorandum of Understanding would terminate as of January 1, 2004.²³

We find this alternative proposal to offer little, if any, improvement over the original Memorandum of Understanding. While this alternative would result in the annual amortization of an additional \$640,000 in deferred costs, it would do so at the expense of foregoing an

20. *See, e.g.*, Docket No. 5360, Order of 11/17/89 at 4 ("in view of the proposed use of this credit line to fund capital investments in generation, transmission, and distribution facilities, a long-term credit instrument would appear to be appropriate. This is especially true from a rate perspective since ratepayers will be benefitting from these facilities over the long term and therefore, capital costs should be spread over a similar period to prevent intergenerational inequities.") *See also* Docket Nos. 5810/5811/5812, Order of 2/8/96 at 25–26, 40–41; Docket Nos. 5483/5484, Order of 5/15/92 (amended 5/19/92) at 17; Docket No. 6495, Order of 11/9/01 (in which the Board rejected Vermont Gas System, Inc.'s proposed deferral of certain costs, after the Department argued that the deferrals would violate the principle of intergenerational equity).

21. Tr. 12/10/03 at 139 – 140 (Chairman Dworkin).

22. Tr. 12/10/03 at 140 (Chairman Dworkin).

23. Central Vermont Direct Brief at 66; Department Direct Brief at 4–5.

earnings cap that Central Vermont has acknowledged it may exceed in 2004.²⁴ Furthermore, even with the \$640,000 of additional amortization, the amounts that the Company would be amortizing on its books would be less than the amortization amounts that it included in its 2004 cost of service.²⁵

We are troubled that the Department has not adequately addressed the serious problem presented by Central Vermont's excessive deferred account balances, especially after we specifically directed the parties to try to propose appropriate remedial measures. The Department's principal witness in support of the Memorandum of Understanding attempted to defend the agreement, but ultimately admitted that the Memorandum does not meaningfully or sufficiently resolve the deferred account problem.

Confirming the concern over deferrals that we elicited from the Department, Central Vermont's Chief Financial Officer and Treasurer, Jean Gibson, forthrightly acknowledged that it is "very, very critical for many many reasons" to clear the deferred account balances from the Company's books.²⁶ We appreciate Ms. Gibson's candid and helpful responses to our inquiries. Her willingness to acknowledge the validity of our concerns and to directly answer our questions gives us some comfort that the Company is open to taking appropriate measures to reduce its outstanding deferred account balances.²⁷

Neither the original Memorandum of Understanding nor the alternative proposal included in Central Vermont's brief would make a meaningful dent in those balances. In fact, under both the original Memorandum of Understanding and the alternative proposal, the pace of clearing the deferred accounts would be slower than it has recently been, given that the Company has now fully amortized certain of its deferral accounts. It is inappropriate to reduce amortizations at a time when the deferred balances have substantially increased.

24. Letter from Kenneth C. Picton, Esq., to Susan M. Hudson, Clerk of the Board, received January 9, 2004.

25. As noted in the findings, Central Vermont's 2004 cost of service included \$2.527 million of new amortizations.

26. Tr. 12/9/03 at 104 (Gibson).

27. At the same time, however, we have not received any evidence in this proceeding as to whether Central Vermont's management incentive plans focus excessively on year-by-year earnings, rather than promote a healthier degree of attention to the long-term financial goal of reducing the Company's deferred account balances.

The Memorandum of Understanding thus fails to take advantage of the Company's relatively strong financial position to reduce deferred accounts to a level that would promote healthier books and greater long-term value to ratepayers.

It is for these reasons that we have concluded that in order for us to accept the Memorandum of Understanding, we *must* impose additional measures to more rapidly reduce Central Vermont's deferred balances.

To determine an appropriate level of amortization for Central Vermont's deferred accounts, we begin with the Company's own analysis, filed in support of its claim that no rate reduction is warranted for 2004. The Company's 2004 cost-of-service analysis includes \$2.527 million in new amortizations of deferred accounts. These amortizations represent the recognition of costs and savings that Central Vermont has deferred (in accordance with accounting orders that the Board has previously issued), and has been holding until the Company's next rate case.²⁸ Even though Central Vermont itself represented new amortizations totaling \$2,527,000 (net of regulatory liabilities) to be appropriate in its 2004 cost-of-service filing, there is no provision in the Memorandum of Understanding requiring that Central Vermont recognize on its books the \$2.527 million of net amortizations. We conclude that we should include such a requirement as a condition of approving the Memorandum of Understanding, with Central Vermont to submit a compliance filing that identifies the specific accounts, the current balances in the accounts, the amortization rates, and whether the accounts are accruing carrying costs.

The Company's 2004 cost-of-service analysis also included an adjustment reflecting a \$1.75 million credit resulting from the sale of its Connecticut Valley subsidiary to Public Service Company of New Hampshire. The \$1.75 million credit is based on a twelve-year amortization of the estimated \$21 million proceeds from the Connecticut Valley sale. To advance the goal of reducing Central Vermont's deferred account balances as rapidly as is practical — a goal that the Board shares with the Company and the Department — it would appear to be more appropriate to apply the entire \$21 million to write down \$21 million in deferred charges, rather than amortizing that amount over twelve years. However, we have no evidence on possible tax

28. Exh. CVPS-JHG-3 at 13. We note that the Board's accounting orders explicitly provide that they are not determinative of the ratemaking treatment of the cost (or savings) at issue.

effects, or other potential consequences, of an immediate \$21 million write-down. We will thus require Central Vermont to file a proposal for applying the \$21 million to write down deferred charges. The proposal must either (1) provide for an immediate \$21 million write-down, or (2) explain why a more gradual write-down is appropriate and provide for the most rapid write-down that is practical. The proposal must also provide that the write-downs are to be in addition to those that are already scheduled and those that we have required above.

Finally, we note our expectation that, in the future, the Company will begin amortizing any deferred expenses as soon as they are incurred, absent a compelling reason not to do so. This would be consistent with not only the significant policy reasons discussed above for recognizing costs as soon as possible, but also fairness to investors who have a substantial interest in an accurate portrayal of the financial obligations of the Company.

3. Other Terms and Conditions

The Memorandum of Understanding provides that Central Vermont will file, within 60 days of approval of the Memorandum of Understanding, to petition the Board for approval of a rate redesign. That filing will be accompanied by a fully allocated cost of service study. In addition, Central Vermont and the Department agree to engage in good-faith negotiations toward development of an alternative regulation plan. These parties have set a target date for filing the plan as 120 days after Board approval of the Memorandum of Understanding. Central Vermont is not required to file a plan absent its consent.

We find both of these provisions reasonable and accept them as part of the Memorandum of Understanding.

V. CONCLUSION

We conclude that with the modifications described above, the Memorandum of Understanding is reasonable. We therefore approve it subject to those modifications. This will have the effect of reducing Central Vermont's Return on Equity to more appropriate levels, freezing rates through the end of 2004, and — most significantly — help reverse the recent trend

of substantial increases in Central Vermont's deferred account balances. As a result, ratepayers both present and future will benefit from rates that are just and reasonable, and the Company will benefit from having its deferred accounts cleared more quickly.

Because this proceeding involves our review of a voluntary agreement between Central Vermont and the Department, those parties each have the right to reject the Memorandum of Understanding as we have modified and conditioned it. Should either party do so, we intend to take such steps as may be necessary and appropriate to address the concerns that we have expressed in today's Order. Those steps would likely include the opening of an investigation into (a) the justness and reasonableness of Central Vermont's rates, and/or (b) the appropriate accounting treatment of Central Vermont's deferred expenses. Fundamentally, it is vital for the Company to use its current favorable earnings to benefit either current ratepayers with a rate decrease, or to benefit future ratepayers by reducing the costs that it is currently deferring.

VI. ORDER

IT IS HEREBY ORDERED, ADJUDGED AND DECREED by the Public Service Board of the State of Vermont that:

1. The Memorandum of Understanding dated July 11, 2003, between Central Vermont Public Service Corporation and the Vermont Department of Public Service is approved, but only if Central Vermont and the Department agree to the modifications and conditions set forth in this Order. No later than February 3, 2004, Central Vermont and the Department shall each file a statement indicating whether it agrees to the modifications and conditions set forth in this Order.

Only if Central Vermont and the Department so agree shall the following conditions apply:

- a. Except as provided in Paragraph 1(b), below, Central Vermont shall not file for any rate increase effective prior to January 1, 2005.
- b. In the event of a major storm, power supply interruption or outage in excess of forecasted outage rates relating to Vermont Yankee or Hydro-Quebec deliveries, Central Vermont may seek emergency rate relief pursuant to 30 V.S.A. § 226(a) or seek an accounting order from the Board permitting deferral of costs associated

therewith. The Department retains its right to contest the ultimate recovery of such booked and deferred costs.

c. During the period July 1, 2003, through December 31, 2005, Central Vermont's allowed rate of return on common equity from its Vermont utility operations shall be 10.25%.

d. Central Vermont shall file a report detailing its core return on equity for calendar year 2003 and each year thereafter through calendar year 2005 by March 1 of the following year.

e. If Central Vermont's calendar-year earned rate of return on common equity from its Vermont electricity utility operations in 2003, 2004 or 2005 exceeds 10.625%, 10.25% or 10.25%, respectively, Central Vermont shall apply the excess first to reduce Account 186.0 (Miscellaneous Deferred Debits) as approved by the Board at the time of such excess returns, and thereafter as otherwise agreed by Central Vermont and the Department and approved by the Board. Central Vermont shall file a report on March 1 of 2004, 2005, and 2006 detailing its core return on equity from the previous calendar year.

f. Beginning January 1, 2004, Central Vermont shall recognize on its books those new amortizations — totaling \$2,527,000 net of regulatory liabilities — that the Company proposed in its "Adjustment No. 34" in its 2004 cost of service filing. Within 30 days of the date of this Order, Central Vermont shall file a statement detailing these amortizations; the statement shall identify the specific accounts being amortized, the current balances in the accounts, the amortization rates, and whether the accounts are accruing carrying costs.

g. Within thirty days of the date of this Order, Central Vermont shall file with the Board for Board approval a proposal for applying the estimated \$21 million payment that it will receive from Public Service Company of New Hampshire to write down deferred charges. The proposal must either (1) provide for an immediate \$21 million write-down, or (2) explain why a more gradual write-down is appropriate and provide for the most rapid write-down that is practical. The

proposal must also provide that the write-downs are to be in addition to those that are already scheduled and those that we have required in Paragraph 2.f, above.

h. Within sixty days of the date of this Order, Central Vermont shall file with the Board a fully allocated cost-of-service study and rate redesign as well as a petition, pursuant to 30 V.S.A. §§ 218 and 225 and Board Rule 2.402, to redesign its rates.

i. Central Vermont shall enter good-faith negotiations with the Department toward the development of an alternative-regulation plan, with a March 31, 2004, target for filing such a plan. Central Vermont shall not be required to file an alternative-regulation plan absent its agreement.

2. All findings and conclusions requested by the parties and not specifically adopted above are rejected.

Dated at Montpelier, Vermont, this 27th day of January, 2004.

| | | |
|-----------------------------|---|----------------|
| <u>s/Michael H. Dworkin</u> |) | |
| |) | PUBLIC SERVICE |
| |) | |
| <u>s/David C. Coen</u> |) | BOARD |
| |) | |
| |) | OF VERMONT |
| <u>s/John D. Burke</u> |) | |

OFFICE OF THE CLERK

FILED: January 27, 2004

ATTEST: s/Susan M. Hudson
Clerk of the Board

NOTICE TO READERS: This decision is subject to revision of technical errors. Readers are requested to notify the Clerk of the Board (by e-mail, telephone, or in writing) of any apparent errors, in order that any necessary corrections may be made. (E-mail address: Clerk@psb.state.vt.us)

Appeal of this decision to the Supreme Court of Vermont must be filed with the Clerk of the Board within thirty days. Appeal will not stay the effect of this Order, absent further Order by this Board or appropriate action by the Supreme Court of Vermont. Motions for reconsideration or stay, if any, must be filed with the Clerk of the Board within ten days of the date of this decision and order.